

**Islamic Banking and Finance:  
Shari 'a -Compliance and the Reinterpretation of Riba**

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**I. Introduction**

The Islamic financial framework is governed by *Shari 'a*, a “body of rules deriving its legitimacy from the theological premise that it is God’s law.”<sup>1</sup> Despite the controversial nature of state intervention and enforcement of *Shari 'a* principles, Islamic banking practices nonetheless purport to follow the precepts mandated under *Shari 'a*, particularly the Qur’an and the Sunna, the primary and secondary sources of *Shari 'a*. In recent years, Islamic banking practices and *Shari 'a* - compliant systems have significantly expanded throughout the world. Since its inception three decades ago, the number of Islamic financial institutions worldwide has risen from one in 1975 to over 300 today in more than 75 countries.<sup>2</sup> They are concentrated in the Middle East and Southeast Asia (with Bahrain and Malaysia the biggest hubs), but are also appearing in Europe and the United States.<sup>3</sup> Total assets worldwide are estimated to exceed \$250 billion, and are growing at an estimated 15 percent a year.<sup>4</sup>

Due to this expansion most research of the Islamic banking movement concerns the compatibility of Islamic and Western banking structures. While I do compare and contrast these two structures, my analysis focuses more on the nature of the *Shari 'a* - compliant structures themselves. Specifically, I examine the underlying principles and whether the goals are being fulfilled. Qur'anic injunctions and Islamic narratives expressly disapprove of *riba*, or interest. Proponents have strictly interpreted this prohibition and created a financial system that is interest- free and predominantly risk sharing. However, what truly constitutes a prohibited increase? Thus, my thesis turns on this critical issue and I argue that *riba* should *not* be interpreted as the complete interdiction of interest.

My analysis will reveal that the prevailing interpretation of riba in the Islamic sources of law creates a deadlock for the implementation and creation of Shari 'a- compliant practices. I illustrate that 1) the concept of 'interest' is still prevalent in these models and is therefore hypocritical; and 2) the models only serve the interest of the wealthy, thereby acting counterproductively to the social justice imperatives of Islamic law. In turn, I assert that the only effective solution is to reinterpret riba for a moderate use of interest. A broader construction of riba would permit greater Shari' a compliance and more equitable distribution of wealth.

## **II. Background**

### **A. Definitions and Sources of Islamic Law**

Shari 'a is the Arabic word for Islamic law and is also known as the 'Law of Allah.' It is important to note that Shari 'a governs all aspects of life and therefore does not distinguish between secular and religious life. There are two primary sources of law in Islam: the Qur'an and the Sunna. The Qur'an is the holy book of Islam and is considered to be the direct words of God and as spoken to the Prophet Muhammad.<sup>5</sup> The Sunna is the rule that is deduced from the sayings of the Prophet in his actions of pronouncement or his approval thereof, which was recorded or became part of tradition. The two last sources, Ijma and Qiyas, become necessary when the Qur'an and the Sunna are insufficient to address an issue. Ijma signifies 'consensus.' That is to say, something is found to be truthful or a rule because it was determined unanimously. Finally, Qiyas is the use of analogy, of something known to be true, to address an unknown situation. Under Shari 'a, these four sources constitute a hierarchy of importance, where the Qur'an is most significant and Qiyas is least. These sources serve as the foundation of Shari 'a and the basis for understanding Islamic banking law. It is evident that scope of Shari 'a is

greater than what we ordinarily consider “law.” Shari'a encompasses every segment of public and private life.

### **B. Objectives of Islamic Law**

Understanding the goals of Islamic law generally is important to understand the meaning and reason behind specific Islamic banking regulations. According to Muslim legal theory, the “purpose of Islamic law is to seek after the righteous path - to try to come as close as possible to it, and in doing so achieve the welfare of the people.”<sup>6</sup> This precept comes from the concept of oneness of God, or *Tawhid*.<sup>7</sup> Next is the notion that from this supreme being came humans, who are God's vicegerents, or *Khalifah* on earth.<sup>8</sup> As *Khalifah*, all human beings are considered equal and are to act in the best well-being of one another.

Thus, this purpose is *tahqiq masalih al-'ibad*: the idea that the pursuit of abstract values, such as justice, compassion and mercy, is supposed to translate into concrete and tangible benefits to be enjoyed by human beings.<sup>9</sup> Specifically, the concept of justice, or *adalah* is a central tenet of the Islamic faith and is a value that governs all aspects of Shari'a.

The Qur'anic ideals of fairness and justice apply to financial affairs. One application of these Qur'anic principles to the area of economics is the following: “The methodology of how man uses resources and means of production to satisfy all his worldly needs, according to a predetermined God-given code in order to achieve the greatest equity.”<sup>10</sup> There are five unique characteristics of how financial affairs are addressed in the Islamic faith:

1. Man, being an agent and not an original owner, is not a free agent in his exploitation of resources and must use methods and means within a framework given to him in the satisfaction of his economic means.

2. The guiding principle of economic activity is the overall good of society and nature (environmental).
3. Individual man, being part of the overall fabric, must be given consideration for his well being.
4. Equitable reward must be given to man according to his effort (to all according to their efforts, and from all according to their abilities).
5. Certain activities in the exploitation of resources, having over-all detrimental effects, are proscribed.<sup>11</sup>

Essentially, Islamic law permits the accumulation of wealth and property ownership, however, only through socially conscious means and in consideration of the well-being of others.

### **III. Islamic Banking and Finance**

The ideology of Islamic banking and finance was born in the 1970's based on the writings of Muhammad Iqbal and Abu Al-A'la Al- Maududi, Bakir Al- Sadr, and Sayidd Qutub.<sup>12</sup> Scholars urge that Islamic finance developed into a sub-field of economics for socio-political reasons. Developed alongside Western economics, the Islamic system of banking and finance was initially based on the Western, capitalist interest-based banking model. With the great influx of wealth and capital that resulted from the oil industry, Islamic banking structures felt an immediate need to rely on Western principles of capitalist banking. The spread of this form of banking system raised increasing realization that such a banking model was strictly prohibited under Islamic precepts and Shari 'a. This awareness fostered a strong resurgence to revive Islamic ideals and galvanized the impetus to institute Shari 'a compliant banking practices. Perhaps the foremost necessity was to eradicate practices based on interest. Hence the Islamic world found itself in the need of an alternative banking model that was Shari 'a compliant and

interest-free, and that also accomplished the same goals as the Western model: a system that would provide the same incentives to lenders and borrowers to enter into financial transactions. The challenge that faces the Islamic banking world today is finding the appropriate model to accomplish this goal. The proper form of an alternative banking models is a highly contested question. As a result, several modes have been proposed and I will discuss each of these finance structures in turn.

### **A. Principles of Islamic Banking**

In order to be Shari 'a compliant, Islamic banking and finance must comport with the fundamental principles of Islamic law. With respect to Islamic banking and finance, this means that such as the notion that wealth accumulation must provide for the greater good of society. Banking practices need not be interest- free to satisfy this condition; rather, since Shari 'a prohibits the accumulation of wealth that is not the product of work, what is also specifically prohibited is capital in return for something that does not constitute work. In a similar vein, risk must lay with all parties in the transaction. Therefore, a model employing a fixed rate of return would violate Islamic principles; instead, Islamic financial transactions mandate the principle of shared risk allocation. Therefore, in order for the parties in a financial transaction to receive any benefit in addition to the principal amount invested, they must share the risks involved in the transaction. In bank transactions, the Islamic bank should share the risk with the consumer.

### **B. Prohibition of Riba and Gharar**

#### **1. Prohibition of Riba**

The notion that Shari 'a permits the accumulation of wealth through socially conscious means indicates that there are a number of ways in which accumulation of wealth is prohibited or is *haram*. These forms include hoarding, gambling and betting in all forms;

cheating in quality, quantity, weight or any specifications of the goods and services traded or acquired or disposed of; all types of fraudulent sale or sales used as an excuse to charge interest, trade malpractices (for example, creating artificial scarcities); and interest in any form and at any rate.<sup>13</sup>

According to Islamic jurists, the prohibition of interest, or *riba*, is aimed at avoiding "the illegality of all forms of gain or profit which were unearned in the sense that they resulted from speculative or risky transactions and could not be precisely calculated in advance by the contracting parties."<sup>14</sup> Thus, *riba* signifies an unjustified increase that constitutes unjust enrichment because it fosters the accumulation of wealth that is not from the product of work.

On the community level, prohibiting *riba* ensures that wealth is accumulated for the benefit of the community.<sup>15</sup> This is demonstrated in the *zakat*, a compulsory wealth tax in the Qur'an, which must be paid to the poor annually.<sup>16</sup> The tax deters wealth from accumulating and concentrating in the hands of a small number of wealthy individuals. By limiting hoarding, the Qur'an encourages a "just return to all members of a society from socioeconomic development." Islamic scholars also posit that social justice is served because prohibiting *riba* discourages unequal bargaining by forcing investors to bear direct risks.<sup>17</sup>

Scholars have also put forth purely economic reasons for the prohibition of *riba*. One argument is that because trade is a pre-determined cost of production, it tends to prevent full employment. Scholars have argued that the unjust allocation of risk between borrower and lender creates a "penalty upon entrepreneurial initiative."<sup>18</sup> In a truly competitive market, Islamic scholars believe it to be unlikely that an investment could result in gross profits that also cover the interest. Since capital would be unproductive without entrepreneurial input, the disincentive to create wealth hinders economic growth.<sup>19</sup> Similar arguments attributing the international

monetary crises have also been made. Studies have not been successful in supporting these theories. Nonetheless, the predominant existing belief is that interest is harmful and exploitative, which is the reason it is prohibited in Islamic sources.

This prohibition of riba is evident in multiple sources of Islamic law: the Qur'an, Islamic records of history, and the Arabic language. The prohibition of riba is mentioned in four different revelations in the Qur'an. The first revelation states that interest deprives wealth of God's blessings.<sup>20</sup> The second revelation condemns interest, by comparing interest to the wrongful taking of property of others.<sup>21</sup> The third revelation opines that Muslims should stay away from interest for their own sake and the sake of others.<sup>22</sup> The fourth revelation discusses the distinction between interest in trade. The premise of the dichotomy in the last revelation is that Muslims should take the principal sum, and to take this amount as long as the borrower is able to repay. The Qur'an indicates that those who disregard the prohibition of interest are at war with God and His Prophet. Specifically, the Qur'anic prohibition of riba reads:

Those who devour [riba]  
Will not stand except  
As stands one whom  
The Evil One by his touch  
Hath driven to madness  
That is because they say:  
"[Sale] is like usury [(riba)]."  
But Allah hath permitted [sale]  
And forbidden [riba].  
Allah will deprive



[Riba] of all blessing,  
But will give increase  
For [voluntary] deeds of charity;  
For He loveth not  
Creatures ungrateful  
And wicked.<sup>23</sup>

The Qur'an goes on to warn:

That they took [riba],  
Though they were forbidden;  
And that they devoured  
Men's substance wrongfully -  
We have prepared for those  
Among them who reject Faith  
A grievous punishment.<sup>24</sup>

The prohibition of riba is also explicitly stated in the Sunna. For instance, one narrative from the authority, Abu Hurayrah relays,

“The Prophet, peace be upon him, said: 'On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received *riba*.' (Musnad Ahmed).”<sup>25</sup>

Although the Sunna discusses riba in narrative form, the account clearly expresses the disapproval of riba. The Prophet condemned not only those who take interest but also those who

give interest and those who record or witness the transaction, saying that they are all alike in guilt.<sup>26</sup>

It may be mentioned in passing that similar prohibitions are to be found in the pre-Qur'anic scriptures, although the 'People of the Book', as the Qur'an refers to them, had chosen to rationalize them. It is amazing that Islam has successfully warded off various subsequent rationalization attempts aimed at legitimizing the institution of interest.<sup>27</sup>

## **2. Interpreting Riba**

There are varying interpretations of the Qur'an, and while there is a clear proscription of riba, the exact meaning of riba remains unclear. Some scholars maintain that there is a distinction between "riba" and "usury," whereby usury is the illegal and unjust collection of interest. The following Qur'anic verse illustrates this interpretation:

O ye who believe!  
Devour not Usury [riba],  
Doubled and multiplied;  
But fear Allah; that  
Ye may (really) prosper.<sup>28</sup>

As a pre-Islamic practice, the majority of those who lived at subsistence level, whose crops would be destroyed during famine or hostile raid, would seek money from lenders. If they could not repay this amount by the specified date, the sum of the amount would be increased, whereby the lender's profit would double and the borrower receives an extension at an exorbitant price.<sup>29</sup> The Hanbali school of Islamic law, declared that the practice of "pay or increase" is the only form of riba targeted by the Qur'an's prohibition that is beyond any doubt. All other occasions and aspects of "increase" in financial transactions remain subject to doubt, and

therefore to disagreement, within the Islamic legal community as to whether the *riba* prohibition applies.<sup>30</sup>

Most Islamic scholars, however, hold a strict interpretation of the Qur'an, or a Classical view, and opine that all forms of interest are prohibited under Shari'a. Scholars hold that due to principles of social fairness and abuses delineated in historical sources, that all forms of interest *riba* constitute prohibited *riba*. They argue that the conventional banking system, based on interest, is fundamentally unjust: First, the management and owners of a bank are sophisticated and will use their market knowledge to increase profits and the institution's net worth.<sup>31</sup> Second, they are protected from their mistakes (arising from their willingness to take risks) by the state and the insurance companies whose premiums are in fact paid by lowering returns to depositors.<sup>32</sup> Third, since depositors are guaranteed a certain rate of return on their deposits, banks place the full risk of lending on the borrower.<sup>33</sup> The proponents of the Islamic banking movement have endorsed this strict interpretationist view and created financing tools that are purported to be "interest-free."

### **3. Prohibition of Gharar**

A key counterpart to the prohibition of *riba* is the prohibition of *gharar*, a term which has been translated as "trading in risk," or "risk-taking." This has been understood as the ignorance of the material attributes of a transaction, such as existence of the subject matter, deliverability, terms, and timing of payment. The issue of *gharar* is traditionally overcome when the parties to a contract have adequate knowledge of the subject matter of the transaction and the counter-values they intend to exchange.<sup>34</sup>

Just as *riba*, the exact definition of *gharar* is unknown and jurists disagree as to the extent of the prohibition of *gharar*. Jurists have debated the presence of *gharar* in those sales in which

the object is not viewed before conclusion of the contract or in which the object is nonexistent at the time of entry into the contract.<sup>35</sup> While many have held that the gharar in these contracts are excessive, others have held it is minimal. If the prohibition of the sale for inexistent items deems the contract invalid, business concerning speculative trading, arbitrage and the like would be strongly impacted.<sup>36</sup>

#### **IV. State Implementation of Shari' a- Compliant Structures**

As far as state implementation of Shari 'a, countries vary in their codification of riba and use of Shari 'a - compliant tools. As mentioned in Part IV of this paper, most modern jurists hold a strict interpretation or a Classical view of riba, that all forms of interest are interdicted. Countries such as Sudan, Iran and Pakistan endorse this view; Sudan, specifically has made the charging of interest a criminal offense, punishable by lashing.<sup>37</sup>

Other nations hold modern interpretations of riba and have codified it as such in their respective Constitutions. The Hanbali school's moderate use of riba is one modern approach. The Kuwaiti Civil and Commercial Codes are symptomatic of the discretionary application of riba. Here, the riba is forbidden in civil transactions, but *is* permitted in commercial transactions subject to a state- declared ceiling of 7%. Subsection (2) of Article 102 of the Kuwaiti Civil and Commercial Codes provides that where interest has been agreed upon and the debtor fails to pay, the deferred interest shall be calculated on the basis of the agreed- upon rate. Compound interest is prohibited and the sum of interest due should never exceed the sum of the loan capital, notwithstanding rates for long- term loans.<sup>38</sup> Countries such as Oman, Qatar and Bahrain accept such modern solutions.<sup>39</sup>

## **V. Comparison to Western Institutions and Capitalist Systems**

Current Islamic financing tools purport to provide interest- free options. As the demand for such options are growing, understanding the compatibility between the Shari 'a - compliant financial models and the conventional banking models has become increasingly central. While the global expansion of Shari 'a - compliant structures may imply that cooperation has been successful, the two types of structures inherently differ in their ideologies. I argue that whether or not riba is implemented, Islamic and Western banking methods fundamentally differ. This is not to say that they are not compatible, but rather that the incentives for profit are for different purposes and goals.

### **A. Sources of Law**

The strongest distinction between Islamic jurisprudence and the Western counterpart, which directly correlates to the differences in banking and finance practices, are the distinct sources of law. In Islam, Shari 'a derives from both religious texts and history- the sources of analogy and reason are employed when the primary sources, the Qur'an and the Sunna are silent. Analogy and reason are then employed to create legal solutions and rules that are in the same vein as the Qur'an and the Sunna. In the Western world, law is derived from the human process- from legal scholars, judges, jurists and the like. This law evolves over time, as it interacts within societies and changes based on the circumstances of particular individuals.

The dichotomy between religious sources and the human process directly impacts the respective economic policies. Since Islamic law is based on religious precepts, its economic policies are also necessarily constructed based on religious aspects. In the Western regime, on

the other hand, there is a separation of Church and State, which as a by-product, prevents economic policies to be based on religion.

### **B. Differences in Objectives and Principles of Interest**

The varying ideologies between Islamic law and Western law, embedded in their legal sources, engenders many points of divergence between Islamic and the Western economic policies.

The Western view of interest is one primary form of distinction. In a capitalist system, making a profit off of an investment, usually in the form of interest, is the key incentive to invest. For instance, for an investor, the incentive to invest in a fund is that the principal amount of money will over time yield a value equal to a certain percentage rate. Similarly, a bank loans money on the basis that it will receive a profit from adding a percentage to the amount to be repaid. With such differing view of “interest,” Clearly consolidating Islamic and Western banking models necessitate a compatibility of two ideological ends.

### **VI. Shari’ a Compliant Model v. the Western Model**

There are significant practical distinctions between a Shari’a - compliant model and the Western model. The issue of risk is one of the most distinguishing features of the banking systems. In traditional banking, the owners of the bank are more at risk than the depositors. The only time when the depositors’ funds are at risk is when the losses are so large that even the capital is written off. Likewise, if there is a banking failure under conventional banking, depositors are guaranteed up to \$100,000 per account.<sup>40</sup>

In Islamic banking, on the other hand, “Islamic bank will mediate the relationship between its aggregate depositors and its aggregate borrowers.”<sup>41</sup> If the Islamic bank is profitable, the depositors are entitled to a share of those profits. If there are losses, then these as well are

distributed to the depositors. The central argument, therefore, is that the owners of the bank are not necessarily more at risk than the depositors, nor are depositors afforded such strong protection as in conventional banking.

Another important area is pricing. For traditional banks, banks will charge the highest interest rate in which they could make a profit, which is low enough to maintain customers and remain competitive. This pricing, that is dependent on the market, will cover certain required expenses for the traditional bank: the expenses for running a bank, a reservation for bad loans, regulatory procedures, and the cost of funds of the bank. The cost of funds for the traditional bank is equivalent to the interest payments.

Islamic banks on the other hand, as mentioned earlier, are based on a profit- sharing transaction. Thus, the bank will attempt to obtain a minimum return on the loan. The minimum return will be computed the same as the traditional bank, with the exception of the cost of funds. As such, the Islamic bank has the same costs; however, instead of interest payments for the costs of funds, the Islamic bank pays their depositors an amount corresponding to the expected profit or loss from investment and lending activities.<sup>42</sup>

## **VII. Forms of Shari' a- Compliant Banking Practices**

Several Islamic financial models have been proposed in an attempt to comply with Islamic precepts while at the same time providing the incentives of capitalist banking systems. As stated earlier, there has been no clear consensus for an efficient model. Rather, several approaches accomplish these goals and fall into the following categories: (1) non-fund transactions, (2) investment activities, and (3) social activities.<sup>43</sup> Non- fund transactions refer to conventional banking practices, which are service- oriented transactions between banks and depositors. Such transactions include depositing and withdrawing money from banks, all of

which is interest- free. Investment activities refer to practices involved with capital financing for industries and trade. The common investment activity tools are the following: *mudaraba*, *musharaka*, *murabaha*, *bai'muajjal*, *ijara*, and *bai'salam*.

#### **A. Mudaraba**

Mudaraba is a profit-and-loss sharing financial system, which is equivalent to venture capitalism. In this type of transaction, an investor trusts an entrepreneur with capital; if the entrepreneur makes a profit, then he would agree to share a certain percentage with the investor yet would be free of any losses. Hence, if there are any losses of capital, only the investor bears the financial loss. Mudaraba is one of the most basic forms of Islamic banking.

This arrangement avoids the use of *riba*. Some may argue that because the entrepreneur does not share the financial loss, that the risk only falls upon the investor, thereby violating the Islamic mandate of risk- sharing. Many Islamic jurists counter this proposition by asserting that the entrepreneur does assume the risk and potential loss of time and effort. It appears that this latter view is heavily supported, perhaps in light of the fact that the Prophet has approved the practice of *mudaraba*.

#### **B. Musharaka**

Musharaka is a capitalistic partnership agreement, whereby investors contribute capital together, sharing the losses and profits on an agreed- upon equation. In this arrangement, clearly without the use of *riba*, the losses and profits are shared among the participants. Like *mudaraba*, *musharaka* is also one of the most basic forms of Islamic banking.

#### **C. Murabaha**

Murabaha constitutes financing on a “cost plus” basis. Here, the bank purchases goods at a certain price and resells it to customers at a higher price. Under traditional banking, the



customer would likely incur fees or interest calculations if there is a default. Under murabaha, the customer is only liable for the contracted good.

One salient argument is that the discrepancy in price may serve as *riba* to the customer. The signal response is that the nature of the transaction places a risk on the bank as well. In other words, earning a profit by reselling the goods at a higher price is justified because the bank carries the risk of customers refusing to accept the goods. This form of banking is considered practically less risky than *mudaraba* and *musharaka*, and therefore is a more common practice.

The following is a typical business transaction that could be used under a murabaha financial tool. Suppose a businessman wishes to go into business selling sailboats. If the businessman's credit history is approved, then a conventional bank would grant a cash loan. At this point, the businessman would use the proceeds to buy the sailboats, and meanwhile owe the bank the funds while paying interest along the way. However, under a murabaha transaction, the bank would instead *buy* the sailboats and the businessman would have to promise to buy it from the bank at a higher price in the future. As I have already mentioned, the increase in price is justified by the bank owning the sailboats, and therefore assuming responsibility for them, in the interim.

#### **D. Bai'muajjal**

This investment activity tool is equivalent to a deferred payment financing. Here, the financial institution purchases the contract for property or goods on a deferred payment schedule and then resells the property or goods to the customer. The financial institution pays the supplier on a progressive schedule, and the customer pays the institution through installments on the progressive schedule. Here as well it appears that the financial institution is interposing a form of

riba; however, since the nature of the transaction is trading rather than lending, the reselling at a higher price is justified.

#### **E. Ijara**

Ijara is a lease transaction in which the financial institution purchases goods, usually machinery or equipment, and leases it to the customer. The customer would pay the institution a rental fee for a set period; if the customer wishes to purchase the good before or after the period, he may do so.

It is important to note that in the Islamic form of lease transaction, the lease begins at the date in which the goods are delivered to the customer, that the customer is not liable for the goods if they are destroyed, and that if there is a purchase of the goods at the end of the lease period, the contract cannot be made binding. These stipulations are different from conventional lease transactions (i.e., in conventional lease transactions, the beginning of the lease date is the date of the contract).

#### **F. Bai'salam**

Bai'salam is a transaction in which the entrepreneur sells his goods to a bank at a price determined in advance of delivery. Therefore, the bank sells the goods to the customer at a price determined during the formation of the contract, and the goods are delivered at a later date.

### **VIII. Recent Developments**

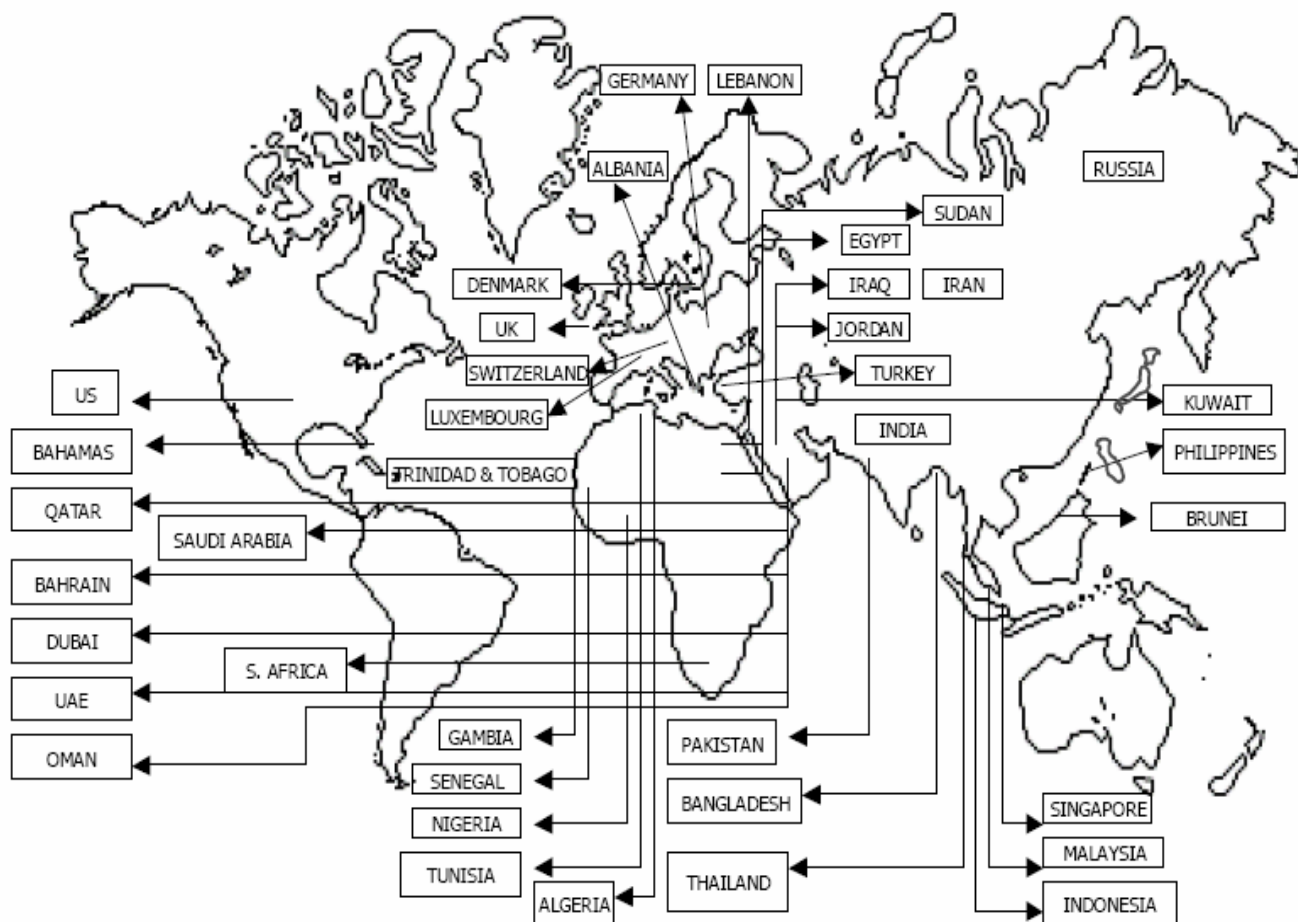
The world's 1.2 billion Muslims are increasingly insisting that their money be invested according to Islamic principles.<sup>44</sup> With the phenomenon of globalization, international investors and businesses are struck with the need to cooperate with Islamic banking laws. The International Organization of Securities Commissions reports annual growth of up to 20 percent during the past decade for the Islamic banking, insurance, and capital markets.<sup>45</sup> It also predicts

that as much as half of the savings of the world's 1.3 billion Muslims will be in Islamic financial institutions by the year 2015.<sup>46</sup> The following table and map prepared by the IOSCO Task Force highlight the growth of the Islamic financial industry since its inception:

### Stages of Evolution of the Islamic Financial Services Industry

1970s	1980s	1990s	2000s
<b>Institutions:</b> - Commercial Islamic banks	<b>Institutions:</b> - Commercial Islamic banks - Takaful - Islamic investment companies	<b>Institutions:</b> - Commercial Islamic banks - Takaful - Islamic investment companies - Asset management companies - Brokers/Dealers	<b>Institutions:</b> - Commercial Islamic banks - Takaful - Islamic investment companies - Islamic investment banks - Asset management companies - E-commerce - Brokers/Dealers
<b>Products :</b> - Commercial Islamic banking products	<b>Products:</b> - Commercial banking products - Takaful	<b>Products:</b> - Commercial banking products - Takaful - Mutual Funds / Unit trust - Islamic bonds - <i>Shariah</i> -compliant stocks - Islamic stockbroking	<b>Products :</b> - Commercial banking products - Takaful - Mutual Funds / Unit trust - Islamic bonds - <i>Shariah</i> -compliant stocks - Islamic stockbroking
<b>Area :</b> - Gulf / Middle East	<b>Area :</b> - Gulf / Middle East - Asia Pacific	<b>Area :</b> - Gulf / Middle East - Asia Pacific	<b>Area :</b> - Gulf / Middle East - Asia Pacific - Europe / Americas - Global Offshore Market

### Geographical Spread of Countries Using Shari' a- Compliant Procedures<sup>47</sup>



Today, Islamic banking is the most developed component of the Islamic financial system, and Islamic banks represent the bulk of the Islamic financial institutions worldwide.<sup>48</sup> The first recognized interest-free commercial bank was the Nasser Social Bank, established in Cairo, Egypt in 1971. With the goals of promoting the social economic progress of member countries and the use of Islamic finance worldwide, the Organization of the Islamic Conference founded the Islamic Development Bank (IDB). The creation of the IDB acted as a catalyst for the

emergence of multiple banks in various countries: In 1975, the Dubai Islamic Bank; in 1977, the Faisal Islamic Bank of Egypt, the Faisal Islamic Bank of Sudan, and the Kuwait Finance House. Rapidly, Islamic banks were established across Asia and in Europe: The Bank Islam Malaysia Bhd in 1983 and the Islamic Bank International in Denmark in 1981.

Currently, there are estimated to be over 256 Islamic banks; total assets are estimated at USD 262 billion and the financial investments are above USD 400 billion. Deposits in Islamic banks are estimated to be over USD 202 billion worldwide and the average annual growth rate of the Islamic banking industry is ranged between 10-20% over the past decade.<sup>49</sup> Essentially, Islamic banks were established parallel to conventional banks. While some countries, as previously mentioned, have instituted Islamic banks, many conventional banks offer banking services based on Shari 'a principles. These components of conventional banks are known as “Islamic windows,” which are often directed by Shari 'a advisors to oversee day- to- day operations. The great global banks—HSBC, Citibank, Deutsche Bank, Standard Chartered, and more— all have either Islamic windows or Islamic subsidiaries.<sup>50</sup> The following is an example of how Deutsche Bank has adopted Shari 'a compliant measures: Since it would be unlawful to issue bonds, or *sukuk* for a promise of a fixed rate of return, the Islamic subsidiary has mandated that the bond have an underlying asset backing it, where the bonds represent an equity asset rather than a loan.<sup>51</sup>

These Islamic windows have also become popular for regional banks. In the US, for instance, regional banks like the University Bank in Michigan and the Devon Bank in Chicago have Islamic windows, with the former now having a full- fledged Islamic subsidiary.<sup>52</sup> The overall effect of Islamic windows and Islamic subsidiaries is the expansion of market capacity and innovation.<sup>53</sup>

Investment funds are another area which has become Shari 'a compliant and expanded globally. These funds include property and realty funds, murabahah funds, and ijarah funds. Property and realty funds have recently become particularly popular in Europe and the Middle East. Between 1994 and the end of 2001, approximately 120 Islamic funds have been launched by both Islamic and conventional institutions.<sup>54</sup> Additionally, the IOSCO reports that Islamic equity funds grew at a rate of 25% between 1987 and 1994.<sup>55</sup> Today, one of the largest global financial institutions, JP Morgan Chase, has established an Islamic subsidiary to meet the requirements of Shari 'a.

## **IX. Impact of Current Islamic Practices and Failure to be Shari' a- Compliant**

The desire for Shari 'a compliant measures was fueled by 1) the need to adhere to the mandates of religious doctrines such as the Qur'an and the Sunna and 2) to fulfill the social justice principles enshrined and envisioned in these religious doctrines. Non- Islamic financial institutions responded to this need by implementing Islamic windows and subsidiaries, which has rapidly expanded globally. The key inquiry therefore, which is addressed in this thesis, is whether the use of alternative banking procedures has actually promoted the goals of Islamic law. In other words, has the use of Shari' a- compliant measures provided for the greater good of society and aided in the reduction of poverty? Many experts hold that Islamic financial practices are even riskier than conventional practices and that they remain options only for the wealthy.

### **A. Theoretical Problems with Currently Proposed Tools**

The earlier hypothetical about murabaha exemplifies the potential high risk. In this hypothetical, the businessman and the bank are involved in a murabaha transaction, whereby the bank purchases the sailboats for the businessman to later purchase at a higher price. The problem here is that "there is no minimum time interval for the bank to own the property before selling it

with the markup.”<sup>56</sup> Some scholars argue that the typical time interval is extremely small and the bank transfers ownership to the client immediately. As murabaha is asset-based, it would be very difficult for a businessman who needs a working- capital loan. The businessman would need cash from the bank to meet expenses for starting the business and a bank would only grant this money in exchange for equity interest in the business. Such a system would be risky for the bank and thus hard to obtain on the part of the businessman.

Experts opine that every Islamic bank has at least three-quarters of its investments structured as murabaha. Even the inaptly named Islamic Development Bank was, as of the mid-1980s, doing four-fifths of its business through murabaha, and only 1 percent through equity transactions.<sup>57</sup> If this is the case, then most financial transactions would appear to serve wealthier entrepreneurs rather than helping the poor. Theoreticians or Islamic economists now urge that the Shari'a - compliant system can only meet the social justice objectives if it not only excludes the mandates prohibited in Islam, but if *includes* those recommended by religion.

The mode of mudaraba as well, has been strongly criticized. Islamic theorists argue that the replacement of pre-determined interest by uncertain profits can be just as exploitative as interest if it is excessive. It has also been argued that historically, mudaraba enabled women and the aged to engage in trade through merchants for a share in the profits, where all losses were borne by the owners of capital.<sup>58</sup> An inequitable allocation of risk would render mudaraba in violation of Qur'anic precepts.

## **B. Case Studies**

Many case studies analyze the Islamic banking systems operating in Egypt, Sudan, Malaysia, and Pakistan. The primary problem identified by the case studies is the high rate of borrower delinquency.<sup>59</sup> In practice, murabaha payments have often been held up because late

payments cannot be penalized under this system. In response, Pakistani banks have employed a “mark-down” practice of giving rebates as an incentive for early payment.<sup>60</sup> This system functions as a form of interest and its legitimacy is debatable.

A case study of the Phillipine Amanah Bank by Mastura highlights other concerns. First, the PAB is a bank that operates by providing both interest on deposits as well as interest-free deposits through Islamic windows. The critique of this form of operation is that the institution is not truly Islamic if it incorporates both practices, especially as it focuses mostly on murabaha transactions as opposed to the mudaraba and musharaka means of financing. Secondly, this PAB also dealt with excess liquidity by making use of interest- bearing treasury bills.<sup>61</sup> The study amply illustrates that financial institutions attempt to be Shari’ a- compliant, yet use indirect forms of interest.

#### **X. Different Interpretation of Riba Is Necessary**

The “interest-free” financial structures described in Part V attain the same result as a conventional “interest bearing” banking structure. In each one, the borrower has little savings and must pay an amount that is above the nominal cost of the loan. In the name of risk sharing, and by incorporating a middleman or indirect path, the methods allow the lenders still to receive a premium. The premium is not labeled as “interest,” but still performs the same definitive role.

Ostensibly, the result of this banking structure is not only that it violates the Qur’anic injunctions and the narratives of Muhammad’s words and acts, but it fails to fulfill the social justice principles of equitable wealth distribution envisioned in the sources in the first place. In order to resolve this problem, I propose that there are two primary options available: 1) Maintain the current Islamic banking structures and modify it such that it could possibly reduce the additional amount burdened on the borrower or 2) reinterpret riba such that it is consistent with



the words of the Qur'an and the principles underlying them. I argue that the first option would not fully redress the problems of Islamic banking. Even if financing tools are altered such that they are more equitable, they will nonetheless incorporate indirect forms of interest. I urge that a reinterpretation of *riba* is necessary to avoid hypocrisy.

Redefining *riba* would accomplish the goals of both adhering to the Islamic law mandates as well as providing a greater opportunity of achieving equitable distribution of wealth. I believe that a moderate interest rate does not qualify as the unjustified or exorbitant increase in price that the Qur'an refers to. One illustration of this interpretation is given by the Hanbali school of thought. The Hanbali school suggests a modest interest rate, one that is less than or equal to the rate of inflation.<sup>62</sup> Thus, at the date of repayment, the interest rate specified in the contract is compared to the prevailing interest rate. This increase will be permitted since it would simply maintain the real value of the capital sum, without “any usurious sums extracted beyond the real value of the capital by examining each transaction retrospectively.”<sup>63</sup>

While I believe that several interpretations of *riba* are conceivable, I propose that in the very least the following rationales would render better solutions than the Classical view: 1) maintenance of the real value of capital is permitted and anything beyond it would be outlawed (as suggested by the Hanbali school; 2) any form of interest that is not exorbitant is necessary for the greater good<sup>64</sup>; and 3) money and interest are newer concepts and outside the scope of *riba* altogether, (because the only forms of currency outlawed by the Qur'an were gold and silver), and therefore permissible.

One potential argument with the moderate use of interest is that the Islamic institution would then be no different from the Western institution. The response is that the two forms of institutions would be inherently distinct because their underlying ideologies are fundamentally

different, and thus the interest would be used to achieve different goals. Under the Islamic framework, profit is used to achieve a spiritual end, and a more centralized governmental power to guide the choice of businesses. The capitalist system, however, seeks profit as an end itself. Moreover, there is vast discretion of individual choice and highly decentralized government in attaining this end. Differences are further underscored through Shari'a mandates other than the prohibition of *riba*. As mentioned in Part V, the banking system further proscribes activities considered *haram*, which include gambling and the alcohol beverage trade. Despite these differences, the use of interest and common desire of attaining profit permit the compatibility of both systems.

## **XI. Conclusion**

The growth of Islamic banking is symptomatic of the global demand of Shari' a-compliant products. This growth illustrates not only the desire to follow the religious mandates and the spirit of Islam, but the social economic capabilities of such a popular system. The current tools are inadequate to fulfill such desires and expectations and provide some difficulty in becoming compatible with the Western banking system. I argue that the only solution would be to provide a moderate form of interest. As a matter of Islamic law, this could only be achieved by a second consensus to the change the prevailing interpretation of *riba*. While some countries *do* endorse alternative views, as opposed to the Classical view, a second consensus will render a uniform agreement of the boundaries of *riba* and provide a powerful movement towards a more equitable distribution of wealth.

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<sup>1</sup> SAMI ZUBAIDA, LAW AND POWER IN THE ISLAMIC WORLD, THE SHARI'A AND POLITICAL AUTHORITY 1-27 (2005).

<sup>2</sup> 42 Mohammed El Qorchi, International Monetary Fund, Islamic Finance Gears Up, Finance and Development Magazine, International Monetary Fund (2005), <http://www.imf.org/external/pubs/ft/fandd/2005/12/qorchi.htm>.

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<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> Hesham M. Sharawy, Note: Understanding the *Islamic* Prohibition of Interest: A Guide to Aid Economic Cooperation Between the *Islamic* and Western Worlds, 29 GA. J. INT'L & COMP. L. 154-58 (2000).

<sup>6</sup> Khaled Abou El Fadl, Article: *The Place of Ethical Obligations in Islamic Law*, 4 UCLA J. ISLAMIC & NEAR E.L. 1-5 (2004/2005).

<sup>7</sup> *Id.* at 5.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Michael J. Taylor, Article: *Islamic Banking- The Feasibility of Establishing an Islamic Bank in the United States*, 40 AM. BUS. L.J. 387 (2003).

<sup>11</sup> *Id.*

<sup>12</sup> Mahmoud A. El-Gamal, 'Interest' and the Paradox of Contemporary Islamic Law and Finance, <http://www.ruf.rice.edu/~elgamal/files/interest.pdf>.

<sup>13</sup> Sharawy, *supra* note 5 at 160.

<sup>14</sup> *Id.*

<sup>15</sup> Chian Wu, Note: *Islamic Banking: Signs of Sustainable Growth*, 16 MINN. J. INT'L L. 233-237 (2007).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> Mohamed Ariff, Islamic Banking, Asian- Pacific Economic Literature (1988), [http://www.usc.edu/dept/MSA/economics/islamic\\_banking.html](http://www.usc.edu/dept/MSA/economics/islamic_banking.html).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> Qur'an, II:276

<sup>24</sup> Taylor, *supra* note 10.

<sup>25</sup> Ariff, *supra* note 20.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> Qur'an, III:130

<sup>29</sup> Barbara L. Seniawski, Notes: *Riba Today: Social Equity, the Economy, and Doing Business Under Islamic Law*, 39 COLUM. J. TRANSNAT'L L. 701 (2001).

<sup>30</sup> *Id.*

<sup>31</sup> Jean-Francois Seznec, Special Feature: *Global Financial Reform, Ethics, Islamic Banking and the Global Financial Market*, 23 FLETCHER F. WORLD AFF. 161, 163 (1999).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> Umar F. Moghul, Esq., Arshad A. Ahmed, Esq., *Fourteenth Annual Philip D. Reed Memorial Issue: Islam and the Law: Contemporary Views and Perspectives: Islamic Law and Finance: Article: Contractual Forms in Islamic Finance Law and Islamic Inv. Co. Of the Gulf (Bahamas) Ltd. V. Symphony Gems N.V. & Ors.: A First Impression of Islamic Finance*, 27 FORDHAM INT'L L.J. 150 (2003).

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<sup>35</sup> *Id.*

<sup>36</sup> *Id.* While the prohibition of gharar is a significant aspect of Sharia- compliant structures, I focus more on the interpretation of riba in my thesis. I argue that a reinterpretation of riba is first necessary for compliance with Islamic precepts.

<sup>37</sup> Kent Benedict Gravelle, *Islamic Law in Sudan: A Comparative Analysis*, ILSA J. INT'L & COMP. L. 1, 19 (1998).

<sup>38</sup> Kuwait Commercial Code, Law No. 68, Art. 115 (1980).

<sup>39</sup> Dr. S. E. Rayner, THE THEORY OF CONTRACTS IN ISLAMIC LAW: A COMPARATIVE ANALYSIS WITH PARTICULAR REFERENCE TO THE MODERN LEGISLATION IN KUWAIT, BAHRIAN AND THE UNITED ARAB EMIRATES, 281 (1991).

<sup>40</sup> Seznec, *supra* note 25.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> S.H. Amin, ISLAMIC BANKING AND FINANCE: THE EXPERIENCE OF IRAN, 15 (1986).

<sup>44</sup> Will Rasmussen, *Islamic Finance Demand Rising, But Depth Lacking*, Reuters, March 27, 2007.

<sup>45</sup> International Organization of Securities Commissions, Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions, Islamic Capital Market Fact Finding Report (2004), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* at 16.

<sup>48</sup> *Id.* at 22.

<sup>49</sup> *Id.* at 27.

<sup>50</sup> Abdulkader Thomas, *Islamic Finance Goes Global*, Far Eastern Economic Review (March 2007), <http://www.feer.com/articles1/2007/0703/free/islamicf.html>.

<sup>51</sup> Aaron Maclean, *Islamic Banking: Is It Really Kosher?* American.Com Magazine, (March/April 2007), <http://www.american.com/archive/2007/march-april-magazine-contents/islamic-banking-is-it-really-kosher>.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> Mohamed Ariff, *Islamic Banking*, Asian- Pacific Economic Literature (1988), [http://www.usc.edu/dept/MSA/economics/islamic\\_banking.html](http://www.usc.edu/dept/MSA/economics/islamic_banking.html).

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> Seniawski, *supra* note 24 at 711

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*